Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:[redacted]:TL-N-1301-99 VIA TELEFAX
[redacted], ID# [redacted] [redacted]

date: JUN 18 1999

to: Chief, Examination Division, [redacted] District
Attention: Revenue Agent [redacted]

from: District Counsel, [redacted] District, [redacted]

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subject: [redacted]
Deductibility of contested liabilities under I.R.C. § 461(f)

The National Office has concurred in part in the advice that we provided to you by memorandum dated April 13, 1999. They have suggested that additional bases for disallowance as discussed below be pursued.

The National Office concurs in your determination that I.R.C. § 468B applies. Attached is a copy of their informal field assistance response which discusses this issue. The informal field service response is not required to be provided to the taxpayer, and we suggest and request that it not be provided since it is protected by the attorney-client privilege.

The National Office bases its position that I.R.C. § 468B applies on the exception language in I.R.C. § 468B(e), which provides that I.R.C. § 468B does not apply except for I.R.C. § 468B(g). The National Office concludes that it applies by noting that I.R.C. § 468B(g) provides the statutory authority for the qualified settlement fund (QSF). This position is not, however, without hazards. A plain reading of I.R.C. § 468B(g) indicates that it applies to clarify the taxation of QSFs, and not to deductibility of a contested liability. In fact, the court in Maxus Energy Corporation v. United States, 31 F.2d 1135 (Fed. Cir. 1994), held that I.R.C. § 468B did not apply to contested liabilities under I.R.C. § 461(f) under the plain language of the statute. Accordingly, notwithstanding our initial and continuing reservations of the applicability of I.R.C. § 468B to this matter, we suggest that you include this issue as an alternative basis for disallowance and complete any necessary factual development as suggested in the informal field assistance from the National Office.

The National Office has also concluded that I.R.C. § 461(h) applies. I.R.C. § 461(h) governs the timing of a deduction. Under I.R.C. § 461(h), a deduction is not allowed until economic performance has occurred. Economic performance generally occurs when payment is made. Id. In Maxus Energy Corporation v. United States, supra, the court held that payment did not occur when a letter of credit was secured since no money was actually paid. The court did, however, find that the economic performance test was met when a cash payment was made to a settlement fund as opposed to the individual claimants. The court in Davies v. Commissioner, 101 T.C. 282 (1993), also seemingly addressed economic performance under I.R.C. § 461(h). The Davies court found that absent the contest, the taxpayer would have been allowed a deduction where it transferred assets beyond its control. Similar to the discussion of I.R.C. § 468B above, the application of I.R.C. § 461(h) to bar deductibility in this case is not free from doubt. The Maxus court noted that the significant factor in determining whether economic performance was met was whether the payment discharged a party's liability.

A strict requirement that actual payment to the individual claimant be required to meet economic performance would create a circular argument and eviscerate the ability in contested matters to transfer money or property to an escrowee or trustee, which is currently permitted both under the Treasury Regulations and decisional case law. Nevertheless, notwithstanding our reservations on the strict interpretation of I.R.C. § 461(h), we suggest that you include in your report, a write-up disallowing the deduction on the alternate basis that economic performance was not satisfied since payment was not made to the claimant in the year in which the deduction was sought. In this regard, as recommended in our memorandum dated April 13, 1999, you may want to determine the precise legal obligations of the taxpayer to the claimant by examining the "escrow" documents and court orders and rules requiring the posting of the bond.

Please contact the undersigned at [redacted] if you have any questions. We are closing our file subject to reopening if additional assistance becomes necessary.

[redacted]
District Counsel

By: [redacted]
Senior Attorney

Attachment:
Copy of informal field
assistance response

cc: [redacted] (w/attachment)

cc: [redacted] (via e-mail) (w/o attachment)

cc: [redacted] (w/o attachment)

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:[redacted]:TL-N-1301-99 VIA TELEFAX
[redacted] ID# [redacted] [redacted]

date: APR 13 1999

to: Chief, Examination Division, [redacted] District
Attention: Revenue Agent [redacted]

from: District Counsel, [redacted] District, [redacted]

subject: [redacted]
Deductibility of contested liabilities under I.R.C. § 461(f)

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES:

1. Whether I.R.C. § 468B applies?

2. Whether the transfer of $[redacted] to a bank in connection with a letter of credit was deductible under I.R.C. § 461(f)?

CONCLUSIONS:

1. I.R.C. § 468B does not apply.

2. Whether the transfer of $[redacted] to a bank in connection with a letter of credit was deductible under I.R.C. § 461(f) depends on whether the funds were to satisfy the judgement or to protect the bank.

FACTS AND DISCUSSION

[redacted] was involved in litigation over a nursing home that it managed in [redacted]. Suit was filed in [redacted]. [redacted] lost the litigation at the trial level in [redacted], and a $[redacted] judgement was imposed against it. The state intermediate appellate and supreme courts affirmed the judgement in [redacted].[1] The United States Supreme Court denied certiorari in [redacted]. [redacted] was required to post a bond to stay enforcement of the judgement. It did so by posting a $[redacted] bond, which it secured with an $[redacted] irrevocable letter of credit. [redacted] was required to deposit $[redacted] with the bank issuing the letter of credit. The taxpayer had on deposit with the bank issuing the letter of credit the amount of $[redacted] at year-end [redacted], which it deducted. Between [redacted], when the letter of credit was issued, and year-end [redacted], the taxpayer made withdrawals and deposits to the bank, although the balance never dipped below the initial $[redacted] deposit.

In your issue write-up, you discuss the application of I.R.C. § 468B and whether the escrow arrangement was a qualified settlement fund. I.R.C. § 468B does not apply. I.R.C. § 468B was enacted to clarify the tax consequences of certain settlement funds established pursuant to a court order for payment of tort liabilities. Johnson v. Commissioner, 108 T.C. 448 (1997). I.R.C. § 468B(e) specifically provides that I.R.C. § 468B does not apply to a contested liability under I.R.C. § 461(f). Rather, we believe that I.R.C. § 461(f) will provide the decisional statutory authority.

I.R.C. § 461(f) provides an exception to the all events test and allows an accrual basis taxpayer to deduct amounts paid to satisfy a contested liability. The funds must be transferred beyond the control of the taxpayer through an escrow or trust arrangement. Treas. Reg. § 1.461-2(c)(1). Neither purchasing a bond to guarantee payment, an entry on the taxpayer's books nor a transfer to an account within the taxpayer's control constitute transfers sufficient to satisfy I.R.C. § 461(f).

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[1] The state appellate court reversed and remanded the interest portion on a limited legal basis which is not relevant to this issue.

The cases under I.R.C. § 461(f) establish the narrow and fact-specific parameters that have been drawn. In Chem Aero Inc. v. United States, 694 F.2d 196 (9th Cir. 1982), the court allowed the deduction where a bond was collateralized by a letter of credit and secured by a certificate of deposit. The judgement was eventually paid upon demand against the letter of credit. The court reasoned that the bond was ninety percent collateralized, and that the funds were the only ones available to and were in fact used to satisfy the judgement. The court noted that a bond purchased for a fraction of the amount of the asserted liability would influence their decision. The deduction was allowed notwithstanding the fact that the taxpayer received the interest income on the certificate of deposit and listed it as a business asset, offset by the liability.

To the contrary, the deduction was denied by the same circuit court in Consolidated Freightways, Inc. v. Commissioner, 708 F.2d 1385 (9th Cir. 1983), where the court distinguished Chem Aero and found that the deposited funds and the surety arrangement was to protect the surety and not to provide for satisfaction of the asserted liability. The court was impressed by the fact that the settlement funds were paid directly by the taxpayer and not from the settlement account. The court was further impressed by the fact that the transaction in Chem Aero was based on the "exigencies of litigation" which left less room for tax avoidance, but that the Consolidated Freightways transaction was established as a reserve.

Following Chem Aero and Consolidated Freightways was Willamette v. Commissioner, 92 T.C. 1116 (1989), where the found that deductions for a letter of credit placed in trust to satisfy the estimated claims of a contested liability were not allowable under I.R.C. § 461(f). The Willamette court reasoned that the letter of credit merely substituted the potential liability to the bank for the contested liability to the judgement-creditor and that there was no economic change in position. The court noted that there was no payment, but only the establishment of a contingent liability reserve. The court further noted that the taxpayer paid only an $85,000.00 fee for a $20 million line of credit and that there was no realistic and practical matching of expenditures and deductions, which was the intent behind I.R.C. § 461(f). The Willamette court noted that the pledge of the certificate of deposit in Chem Aero may have been the crucial factor necessary to satisfying I.R.C. § 461(f), a fact which was not present in Willamette. See also Davies v. Commissioner, 101 T.C. 282 (1993). This is consistent with the "same dollars" or "same money" argument used by the Consolidated Freightways court, which found that the use of the same money put aside for the settlement fund would diminish tax avoidance by precluding deduction acceleration.

Another case that created boundaries for deductibility under I.R.C. § 461(f) was Varied Investments, Inc. v. United States, 31 F.2d 651 (8th Cir. 1994). Like [redacted], the taxpayer in Varied Investments lost a lawsuit. It was required to post a supersedeas bond in an amount representing 125% of the judgement. A surety company issued the bond. The taxpayer secured its obligations under the indemnification agreement by pledging securities in the amount of $6,700,000.00 to an escrow agent. The judgement was paid from the escrow agent. The court analyzed whether the arrangement was the mere purchase of a bond or a true escrow arrangement. The court was impressed with the fact that the account was not a contingent liability reserve, but a payment after the liability determination, which the court found precluded tax abuse.

The Internal Revenue Service has predominately prevailed in those cases where the taxpayer set up what was more in the nature of a contingent liability reserve, which the courts felt had tax abuse potential due to the ability of the taxpayer to determine the timing that the deduction could be claimed. Where the "exigencies of litigation" dictated the property transfer, the Internal Revenue Service has not prevailed. Poirier v. McLane Corp. v. Commissioner, 547 F.2d 161 (2d Cir. 1976), cert. denied 431 U.S. 967 (19977); Chem Aero Inc. v. United States, supra; and Varied Investments, Inc. v. United States, supra.

From a review of the cases, it is apparent that the precise facts involved in the transaction are important. In this case, [redacted] lost the litigation and was required to post a bond to forestall collection on the judgement while it appealed. Therefore, the transaction was motivated by the "exigencies of litigation" and not by a desire to establish a contingent liability reserve, a significant factor in its favor. To post the bond, [redacted] secured an irrevocable line of credit. The bank required [redacted] to deposit $[redacted] for the letter of credit.

Whether [redacted] is entitled to the deduction and the amount of the deduction is dependent on the relationship between [redacted] and the bank. If: (1) the $[redacted] (or other amount) was intended to be used as a funding source for satisfaction of the judgement; (2) the taxpayer was unable to withdraw these funds; and (3) the actual funds deposited in the bank were used to fund part of the judgement/settlement, then we believe that the court will find that the relationship was a true escrow arrangement and allow a deduction to the extent of the funds that were irrevocably placed outside the control of the taxpayer.

The factual relationship between [redacted] and the bank must be determined. For example, we understand that the bank initially required a $[redacted] deposit. We further understand that between [redacted] and year-end [redacted], substantial funds were deposited and withdrawn, but that the balance never dropped below the $[redacted] initial deposit. [redacted] deducted the amount of $[redacted], which was the balance at year-end [redacted]. However, if the only funds subject to the escrow arrangement were the $[redacted] and [redacted] could have withdrawn the difference between the $[redacted] balance, then the deduction would be limited to $[redacted]. Based on information faxed to us on February 19, 1999 from Revenue Agent [redacted], it appears that the amount in the "escrow fund", which totaled $[redacted] was in fact used to pay off the bond.

Based on the fact that the "escrow funds" were used to pay the judgement/settlement, it appears that the "escrow fund" was intended to be used for this purpose. Assuming that the documents concerning the relationship between [redacted] and the bank are consistent with the escrow arrangement and not merely to protect the bank, then the amount of the escrow will be deductible, the only issue being how much. It is not dispositive that the escrow balance was $[redacted] at year-end [redacted]. Rather, it is the amount that [redacted] was required to maintain as an escrow that is important. In this regard, [redacted] made an initial $[redacted] deposit, and multiple deposits and withdrawals between [redacted] and [redacted]. If [redacted] was required to maintain only a $[redacted] balance in the escrow account, then we conclude that only that amount would be deductible.

To make these factual determinations, we suggest that you secure copies of the letter of credit, and reimbursement, security, guaranty and pledge agreements in order to determine the relationship between the parties. The relationship evidenced by these documents should be an escrow arrangement, whereby the beneficiaries of the funds would be [redacted] and [redacted] or [redacted] the company posting the bond. The bank would be required to pay over the funds upon delivery of the letter of credit as part of the arrangement. We also suggest that you secure any correspondence which sets forth or discusses the relationship.

We also suggest that you secure copies of the certificate of deposit or other deposit and withdrawal information which establishes the extent to which [redacted] was required to keep funds in the bank and the minimum funds required.

Please contact the undersigned at [redacted] if you have any questions. Our file remains open to assist you further with the factual development and legal analyses involved herein.

Attached is a client survey which we request that you consider completing. The client survey is an attempt to measure your satisfaction with the service provided by this office. We expect to be able to use your response to improve the services that we provide to you.

[redacted]
District Counsel

By: [redacted]
Senior Attorney

cc: [redacted]

cc: [redacted] (via e-mail)

cc: [redacted]